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FOREWORD

The Management and Budget Act (Sections 18.1483 – 18.1489 of the *Michigan Compiled Laws*) requires that the head of each principal department shall establish and maintain an internal accounting and administrative control system. The Act also requires that the head of each principal department shall report biennially on any material inadequacy or weakness discovered in connection with the evaluation of their system. Finally, the State Budget Director must develop ***a general framework*** and ***a system of reporting*** for use by the principal departments in performing and reporting upon evaluations of their internal control system. These guidelines are to be developed in consultation with the Auditor General.

The following document, developed in consultation with Auditor General, provides the required guidance associated with the evaluation of internal controls in Michigan State government. The document includes two major sections: the General Framework and a System of Reporting. The General Framework provides the *basic structure* for planning and conducting evaluations of a department's internal control structure with references to "evaluation tool sets" that are constructed using the same concepts.   Departments are encouraged to obtain, review, and modify these evaluation tools to best address the unique requirements of their department's environment. Guidance related to correspondence that must be prepared in connection with this evaluation process is identified in the System of Reporting section.

Evaluation of Internal Controls- A General Framework and System of Reporting is a comprehensive revision to the guidance that was last issued in 1990. This new guidance is based upon terminology and concepts set forth in the report, *"Internal Control-Integrated Framework,"* which was prepared by the Committee of Sponsoring Organizations of the Treadway Commission (often referred to as "COSO").

Please direct questions related to this document to the State of Michigan Office of Financial Management at (517) 373-1010.

                              Prepared by:

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GENERAL FRAMEWORK

Overview

The General Framework section of this document provides a basic structure to those performing evaluations of their internal accounting and administrative control systems[1] within the departments and agencies of Michigan State government. This basic structure consists of the following:

- standard terminology and concepts related to internal control,

- a definition of the objectives and components of internal control which must be considered in all internal control evaluations (regardless of the evaluation tool used), and

- guidance for planning and conducting an evaluation of the internal control structure.

This general framework is based upon the widely accepted internal control framework[2] developed by COSO, which is the acronym for the Committee of Sponsoring Organizations of the Treadway Commission - the federally sponsored group responsible for its development. This framework emphasizes that the system of internal control, in any organization, is intended to provide reasonable assurance regarding the achievement of objectives related to effective and efficient operations; reliable financial reporting; and compliance with laws, rules, and regulations.

In Michigan State government, the State Budget Office, through this general framework, encourages managerial staff to conduct internal control evaluations by analyzing the environment and processes by which it pursues its primary business[3] objectives. This pertains to each department's core business processes and supporting activities, which include both financial and non-financial activities. To complement the principles outlined in the general framework, the State Budget Office is committed to researching, refining, and distributing evaluation tool sets that may be used by the State's managerial staff. However, experience indicates that these tools will be of greatest use if tailored to the unique characteristics of your department. Therefore, we have made these tools available in electronic format via the world-wide-web site of the Office of Financial Management (URL: http://www.state.mi.us/dmb/ofm/).

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[1] Internal Control, Internal Control Structure, System of Internal Control, and *Internal Accounting and Administrative Controls* are referred to interchangeably throughout this document.

[2] "Internal control framework," "COSO control framework" and the "COSO report" are used interchangeably throughout this document in reference to the report issued by COSO - "Internal Control – Integrated Framework."

[3] "Business" as used throughout this document pertains to the core processes and activities of Michigan State government organized to support achievement of departments' missions, goals and objectives.

Definition of Internal Control

Internal control is defined as a process, effected by the director, management, and support staff of each State department, designed to provide reasonable assurance towards accomplishment of each principal department's mission, objectives and goals. Each principal department has a unique mission; however, the underlying business strategy, objectives and goals of all departments are typically related to **desired performance** associated with effective and efficient operations; development of reliable financial reports; and compliance with applicable laws, rules, and regulations.

The Management and Budget Act (Sections 18.1483 – 18.1489 of the *Michigan Compiled Laws*) requires that the internal control system of each principal department include, at a minimum, all of the following elements:

- A plan of organization that provides separation of duties and responsibilities among employees.
- A plan that limits access to that principal department's resources to authorized personnel whose use is required within the scope of their assigned duties.
- A system of authorization and record-keeping procedures to control assets, liabilities, revenues, and expenditures.
- A system of practices to be followed in the performance of duties and functions in each principal department.
- Qualified personnel that maintain a level of competence.
- Internal control techniques that are effective and efficient.

These elements pertain to all business processes of the department, including both financial and non-financial activities.

Further, the Act requires each principal department to maintain *documentation of its internal control system*. Meaningful documentation of the internal control structure should facilitate management's ability to document risks and controls, to effectively react to changes in the system, and to substantiate conclusions about the effectiveness of the department's internal control structure.

The remainder of this document discusses requirements for an effective internal control structure, incorporating concepts and terms introduced by the COSO control framework. The COSO control framework is consistent with requirements contained in the Management and Budget Act. In addition, concepts included in the COSO control framework provide for a common foundation upon which departments can better comply with the Act and, at the same time, incorporate best practices demonstrated by other private and public entities that have implemented this widely accepted internal control framework.

Fundamental Concepts

The definition of internal control, and the objectives that it seeks to attain, reflects several associated fundamental concepts that are useful in understanding and applying internal control standards discussed throughout this document. The following sections represent some of the fundamental concepts.

Internal Control is an Ongoing Process
Internal control is not a single event, but a series of actions and activities that permeate a department's operations. These actions are inherent in methods used by management to conduct the day-to-day operations of the department.

Internal control should not be viewed as a separate, specialized system within an agency, but rather as an integral part of the business processes administered by management to achieve its organizational objectives. An effective internal control system is characterized by controls "built into" a department's infrastructure rather than controls added "on top of " the infrastructure. It is a prerequisite to efficiently and effectively managing State government operations.

Internal Control is Affected by People
People make internal control work. The head of each principal department is ultimately responsible for maintaining an effective internal control structure. However, management achieves this through delegation to and performance of specific responsibilities by **all** employees in the organization. Consequently, it is imperative that people clearly understand their responsibilities and limits of authority and how these influence the overall effectiveness of the department's internal control structure.

It is people that define measurable business objectives, initiate control mechanisms and activities, and monitor how well controls assist in achieving the established objectives.

Internal Control Provides Reasonable Assurance, not Absolute Assurance
Regardless of how well designed and operated, internal control cannot provide absolute assurance that all objectives will be met. Management must design and implement internal control based upon related costs and benefits. Once in place, internal control provides only reasonable assurance of meeting objectives. Errors in human judgement, management's capacity to override controls, and acts of collusion to circumvent controls can hamper achievement of objectives.

Nevertheless, an effective internal control structure provides management with the best assurance that "surprises" will be minimized and that the department will achieve its objectives.

Internal Control is Focused on Achievement of Objectives in Separate, but Overlapping Categories
A department's mission, objectives, and goals relate to one or more of the following categories of objectives:

- **Operational** – relates to effective and efficient use of the department's resources. Safeguarding of assets is included as part of this objective.
- **Financial reporting** – relates to preparation of reliable financial statements and schedules.
- **Compliance** – relates to the department's compliance with applicable laws, rules, and regulations.

The category into which a department's specific objectives relate depends upon specific circumstances of an event, transaction, or the environment of the department. Some objectives are common to all entities (e.g., producing reliable financial reports, and complying with laws and regulations). Others, particularly those related to operational efficiency and effectiveness, are department-specific and directed at the individual mission and goals of the agency.

Internal Control is Comprised of Five Interrelated Components
The five components of internal control are based on the way management conducts its business, and each are integrated into the overall management process – planning, organizing, directing and controlling.

- ***Control environment:*** The core of any business is its people - their attributes, including integrity, ethical values, and competence - and the environment in which they operate. They are the power source of the department and foundation on which everything rests.

- ***Risk assessment:*** The department must be aware of and deal with the risks it faces. It must set objectives, integrated with financial and other activities so that the organization is operating in a coordinated manner. It also must establish mechanisms to identify, analyze and manage the related risks.

- ***Control Activities:*** Control policies and procedures must be established and executed. This will help ensure that the actions identified by management as necessary to address risks (related to achievement of the department's objectives) are effectively carried out.

- ***Information and Communication:*** Surrounding these activities are information and communication systems. These systems enable departmental employees to capture and exchange information needed to conduct, manage, and control its operations.

- ***Monitoring:*** The entire process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant. The State of Michigan's biennial evaluation and reporting process is an important component of monitoring.

Limitations of Internal Control

A fundamental concept underlying the definition of internal control is that an internal control structure provides only reasonable assurance that agency objectives will be achieved. Limitations are inherent in all internal control systems. These result from poor judgement in decision-making, human error, management's ability to override controls, collusion to circumvent control, and consideration of costs and benefits relative to internal control. No matter how well internal control operates, some events and conditions are beyond management's control.

Judgement Mistakes
Effective internal control may be limited by the realities of human judgement. Decisions are often made within a limited time frame, without the benefit of complete information, and under time pressures of conducting agency business. These judgement decisions may affect achievement of objectives, with or without good internal control. Internal control may become ineffective when management fails to minimize the occurrence of errors (e.g., misunderstanding instructions, carelessness, distraction, fatigue, or mistakes).

Management Override
Management may override or disregard prescribed policies, procedures, and controls for improper purposes (e.g., to enhance presentation of their agency's financial or compliance status). Override practices include misrepresentations to state officials, staff from the central control agencies, auditors, or others.

Management override must not be confused with management intervention (i.e., the departure from prescribed policies and procedures for legitimate purposes). Intervention may be required in order to process non-standard transactions that otherwise would be handled inappropriately by the internal control system. A provision for intervention is needed in all internal control systems since no system anticipates every condition. Management's actions

to intervene in internal control should be documented and disclosed to appropriate personnel.

Collusion
Collusion activities can result in control failure. Individuals, acting collectively to perpetrate and conceal an action from detection, may alter financial data or other information in a manner that cannot be identified by the internal control system.

Cost versus Benefits
The cost of internal control must not exceed benefits to be derived. Potential loss, associated with exposure, should be weighed against the cost to control it. Although the cost-benefit relationship is a primary criterion to be considered in designing internal control, the precise measurement of costs is generally not possible. The challenge is to find a balance between excessive control (which is costly and counterproductive) and too little control (which exposes the State of Michigan to increased and unnecessary risks). Management is responsible for maintaining effective internal control and has the final decision regarding the costs versus benefits of internal control.

Roles and Responsibilities

The Management and Budget Act prescribes duties and responsibilities of the department director, employees, and internal auditor pertaining to internal control. The Act is consistent with the roles and responsibilities prescribed by the COSO report.

Everyone in the department is responsible for internal control. However, the head of each principal department is ultimately responsible for the ownership and maintenance of an effective system of internal control. Others within the organization are responsible to ensure that effective internal controls exist within their particular function or area of activity. Many external parties, including independent auditors and business partners (e.g., customers, vendors, etc.), contribute to an effective internal control through independent reviews (e.g., attestation or via corroborating evidence about the department's performance).

The roles and responsibilities of management, staff employees, and internal auditors are described below:

Management
The head of each principal department is directly responsible for all activities of the department, including maintenance of an effective internal control structure. Their influence on internal control cannot be overstated.

The various levels of management have different internal control responsibilities. All departmental managers (i.e., managers of specified business processes / activities) are responsible for maintaining internal controls for the activities they manage. They must provide clear instructions and guidance for effective internal control policies and procedures within their areas of responsibility.

The Chief Financial Officer (CFO) and the Chief Information Officer (CIO) play an important role in maintaining an effective internal control structure. The nature of processes they direct often "cut across" numerous activities of the department (i.e., they provide support to one or more of the department's core business processes). These positions are often involved in department-wide planning, budgeting and business process improvement efforts. Related to this, they typically track and analyze performance from operations, compliance, and financial perspectives.

As members of senior management, the CFO and the CIO contribute significantly to the tone of the organization with regard to ethical and moral conduct. They can highlight the importance that should be communicated related to the overall objectives of an effective internal control structure.

Non-Managerial Employees
Non-managerial employees play an important role in developing and maintaining the internal control structure. They may produce information used in the internal control system or take actions needed to affect control. The care with which these activities are performed directly affects the internal control system. Non-managerial employees are responsible for communicating information about problems – non-compliance with rules or policies, illegal acts, etc. – to higher levels in the department. To involve non-managerial employees in internal control, management must stress the importance of internal controls and communicate the roles and responsibilities of each person.

Internal Auditors
Internal auditors play an important role in evaluating the effectiveness of control. Internal auditors serve as an extension of senior management acting to independently verify the integrity of the department's system of internal control. The Institute of Internal Auditors (IIA) *Statement of Responsibilities of Internal Auditing* states, in part, that internal auditors should: review the reliability of financial and operating information, review systems established to ensure compliance, review the means of safeguarding assets, appraise how resources are employed, review program results compared to stated objectives, and inform the department head of problems and deficiencies.

These responsibilities are consistent with the internal auditor's role as defined in the Management and Budget Act.

All organizational activities are potentially within the scope of the internal auditor's responsibility. Because of organizational position, authority in a department, and objectivity with which it carries out its activities, the internal audit function plays a significant role in monitoring internal controls.

Components of Internal Control

Internal control consists of five interrelated components, which are derived from methods used by agencies to conduct their business. Internal control is part of the department's operating activities, and links among these components form an integrated system that allows management to dynamically react to changing conditions. The components of internal control are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Each component is integrated into the management process (i.e., planning, organizing, directing and controlling) and is essential to achieving the objectives of internal control.

The five components also serve as <u>criteria</u> for evaluating the effectiveness of the internal control structure. Each of these criteria must be satisfied according to the unique needs of the department, and underlying activities, being evaluated. The fact that the components serve as both requirements <u>and</u> criteria is very important. This allows management to establish, maintain, and evaluate using the same standard.

Establishing *measurable* objectives, at both the department-wide and activity levels, is a prerequisite to effective internal control. The objectives should be consistent with the overall mission of the department and provide a target, which guides each department in conducting its activities. All departmental objectives and goals are categorized into the following separate, but overlapping objectives of internal control:

- Efficiency and effectiveness of **<u>operations.</u>**
- Reliability of **<u>financial reporting.</u>**
- **<u>Compliance</u>** with laws and regulations.

Evaluating the effectiveness of an internal control structure is a matter of management's subjective judgement. This requires an assessment about the presence and proper functioning of each component of internal control and its contribution towards the department's achievement of the objectives of internal control. The basic structure and tools for evaluating internal controls of Michigan State government are constructed in reference to these five components.

Control Environment

The control environment encompasses the attitudes and actions of management regarding control. This environment sets the organizational tone, influences control consciousness, and provides a foundation for an effective system of internal control. The control environment also provides the discipline and structure for achieving the primary objectives of internal control.

Within the control environment, management assesses risks to the achievement of specified business objectives. Included is the concept of acceptable risk and cost versus benefit. All risks, regardless of the apparent materiality, should be brought to the attention of senior management. Senior management reviews and assesses all risks on a department-wide basis and determines which are unacceptable. Cost is a significant consideration in deciding how much control is needed. Typically, the cost of the control should not exceed the benefit derived. The final decision of "how much control" is the responsibility of senior management, is often arrived at in consultation with the internal auditor.

Control activities are implemented to ensure that management directives to address risks are fulfilled. Major elements that significantly affect a department's control environment follow:

Assignment of Authority and Responsibility
This includes assignment of authority and responsibility for operating activities, establishment of reporting relationships, and authorization protocol. For an agency to accomplish its mission and business objectives, management must delegate authority and responsibility throughout the organization. Critical internal control challenges include delegating to achieve objectives, but not to the degree that internal control is significantly weakened, and ensuring all personnel understand the agency's objectives. With increased delegation of authority and responsibility, management must use effective procedures to monitor results. Individuals must know how their actions interrelate and contribute to the achievement of objectives, and that they are accountable for their decisions and actions.

Commitment to Competence
Managers and employees must maintain a level of competence to ensure accomplishment of their assigned duties. Management must specify the competence level for particular tasks and translate those levels into requisite knowledge and skills. Skills depend upon individual level of knowledge, training, and experience.

Human Resource Policies and Practice
Agencies must establish effective practices for hiring, orienting, training, supervising, evaluating, counseling, promoting, compensating, and disciplining personnel.

Integrity and Ethical Values
Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of other internal control components. Senior management plays a key role in establishing and maintaining the organization's ethical tone. Although policies state management's goals, the culture of the organization will often be an important factor in determining what actually happens – which rules are obeyed or ignored. The way in which senior management communicates and reinforces its values is critical.

All employees should be informed as to organizational expectations and standards. Guidance should clearly communicate acceptable and moral behavior. Finally, the actions and words of management should limit temptations for non-compliance to achieve short-term gains.

Management's Philosophy and Operating Style
This element addresses management's willingness to take business risks. Also included is how the department is managed. Typically, this is done informally via face-to-face contact and/or formally via written policies, procedures, and performance indicators. Other aspects of this element include management's attitude toward audit citations, financial reporting, aggressiveness or conservatism when selecting available accounting principles, the manner in which accounting estimates are developed, and the use of information technology.

Organizational Structure
Organization of an agency provides management the overall framework for planning, directing, controlling, and monitoring achievement of its business objectives. Sound internal controls require that the department's organizational structure clearly define key areas of authority and responsibility, and establish appropriate lines of reporting. Appropriateness of the structure depends, in part, upon the department's size and core business processes, which will dictate the extent to which the department carries out its responsibilities in a centralized or decentralized manner.

Oversight Groups
Michigan State government includes various oversight bodies (e.g., the State Administrative Board, legislative committees, advisory councils, and the Office of the Auditor General). These oversight bodies are mechanisms intended to monitor and improve State operations and programs. Each department needs to be aware of these oversight bodies and determine whether they are in compliance with requirements placed upon them during its normal operating activities.

All of these elements affect the department's overall control environment, which in turn affects the achievement of overall objectives and related sub-objectives. Each permeates the day-to-day activities of the department. For example, without clear lines of authority and responsibility for the outcome of objectives there is no way to ascertain why objectives were not achieved. The concept of holding employees responsible for specific activities via policies and procedures and associated performance criteria is necessary to achieving the department's mission.

Implementation and Evaluation Guidance:

Assignment of Authority and Responsibility

1. Make assignments for responsibility and authority in the department to create or assign the following:
   a. departmental goals and objectives
   b. operating functions
   c. regulatory requirements
   d. information systems
   e. authorizations for changes

2. Authority and responsibility should be explicitly assigned to employees throughout the department. Responsibility for decisions should be related to and commensurate with the delegation of authority.

3. Establish appropriate control-related standards and procedures and include them in current job descriptions for applicable positions.

4. Periodically review the size of the department's staff in view of the following factors:
   a. appropriate number with requisite skills in relationship to complexity of activities and systems
   b. adequacy of work force, in numbers and experience, to carry out the mission of the organization

Commitment to Competence

1. Establish formal, written job descriptions to define tasks comprising the jobs/positions within your department.
   a. Formally analyze the tasks comprising the job.
   b. Consider the extent to which individuals must exercise judgement.
   c. Consider the extent of supervision needed.
   d. Formally analyze and document the knowledge and skills needed by individuals to perform the job.

e. Adhere to personnel rules for hiring, performance evaluation, discipline, and compensation.

2. Evaluate the knowledge and skills exhibited by employees in performing their jobs.
    a. Document evidence showing employees appear to have these skills and knowledge.
    b. Provide training opportunities for all employees, as necessary, to update and increase their knowledge and skills.

Human Resource Policies and Practices

1. Establish written policies for hiring, training, promoting, and compensating employees.
    a. Follow the Michigan Department of Civil Service Commission Rules and State Personnel Director Regulations, as appropriate for your organization.
    b. Personnel policies and procedures should result in recruiting or developing competent, trustworthy people who support an effective internal control system.
    c. Communicate the department's expectations about the skill-sets for people to be hired and about whom should participate in the hiring process.
    d. Establish performance evaluation schedules to at least coincide with promotion and salary increase reviews.
        • Employees need to know what is expected of them prior to advancement or promotion.
        • Evaluation criteria should reflect an adherence to standards of conduct.

2. Establish procedures for making new employees aware of their responsibilities and of your expectations.
    a. Employee evaluations should be done at least annually, to ensure employees are kept aware of their responsibilities and of what is expected.
    b. Written communication of employee responsibilities and of management expectations can be included in job descriptions.

3. Formalize a plan of appropriate remedial action to be taken in response to departures from approved policies and procedures.
    a. Take appropriate corrective action when established policies are violated.
    b. Communicate to all employees, so they understand remedial consequences will follow non-compliant performance.

4.   Establish a formal procedure for adequate employee-candidate background checks.
     a.   Be cautious of candidates with gaps in employment history or frequent job changes.
     b.   Investigate all criminal records.
     c.   Follow-up reference letters and contact past employers during the selection process.

5.   Establish procedures to ensure compliance with the Michigan Department of Civil Service Commission's Rules and the State Personnel Director's Regulations for classified employees.
     a.   Personnel actions should be performed by, or monitored by, personnel professionals.
     b.   Personnel records must document compliance with required policies and procedures.

Integrity and Ethical Values

1.   Establish comprehensive written policies or codes of conduct to address the following:
     a.   acceptable business practices
     b.   prevention of conflicts of interest
     c.   procedures for disclosure of potential conflicts
     d.   expected standards of ethical and moral behavior
          • to prevent illegal or improper activities
          • to report illegal or improper activities

2.   Establish a plan for implementation of the policies.
     a.   Policies should be distributed to all employees and periodically acknowledged by all employees.
     b.   Employees should understand what behavior is acceptable and unacceptable.
     c.   Employees should know what to do if they encounter unacceptable behavior.
     d.   Provide a clear channel for employees at all levels to communicate with senior management regarding ethical and moral concerns.
          • Establish a process for investigating such problems.
          • See that employees understand there are "whistle blower" statutes to protect them from retribution if they call attention to such problems.

3.   Set a "tone at the top" to give moral guidance about what is right and wrong.
     a.   Communicate, by words and by deeds, management's commitment to integrity and ethics.

b. Employees should feel peer pressure to do the "right" thing.
c. Deal with problems, such as customer complaints, slow responses, or high turnover, in a timely and appropriate manner.
d. Actively identify potential problems and deal with them, even when the cost of dealing with them could be high.

4. Establish, and communicate throughout the department, appropriate steps of remedial action to be taken in response to departures from *statutes, rules, approved policies and procedures, and codes of conduct.*
   a. Ensure that management responds to violations of behavioral standards.
   b. Communicate to all employees when disciplinary action is taken as a result of violations.

5. Provide guidance on the type and frequency of situations in which circumvention of, or intervention to, established control policies may occur.
   a. Explicitly prohibit *management override* of established controls.
   b. Investigate and document all deviations from established policies.
   c. Appropriately document and explain all incidents of necessary *management intervention.*

6. Set realistic performance targets, particularly for short-term results.
   a. Avoid extreme pressures or temptations, which unfairly or unnecessarily test adherence to ethical values.
      - Set policy to remove extreme pressures.
      - Establish controls to reduce temptations.
   b. Base rewards largely on achievement of short-term performance targets.
   c. Employees need to understand how the larger, long-term issues relate to short-term performance.

Management Philosophy and Operating Style

1. Establish goals and policies to help achieve low personnel turnover in the following key functions:
   a. operations
   b. accounting
   c. information systems
   d. internal audit
   e. all management and supervisory positions

2. Establish procedures for periodic analysis of employee turnover patterns, particularly among key financial or internal audit staff, to identify any correlation with the emphasis placed on control.

3.	Establish procedures for analysis of management's attitude toward the accounting function, reliability of financial reporting, and safeguarding of assets.
	a.	Accounting should be viewed as a vehicle for exercising control of the organization's activities.
	b.	Management should sign off on accounting reports of results.
	c.	Decentralized accounting and budget personnel should be accountable (in part) to central financial officers.
	d.	Valuable assets, including intellectual assets and information, should be protected from unauthorized access or use.
	e.	Establish a cash-management plan for regular reconciliation of cash received to cash deposited.
	f.	Notify key staff of both agency and statewide financial management policies (and any changes).

4.	Establish a quality management initiative in your agency.
	a.	A quality management plan should have specific goals.
	b.	All employees should be familiar with the plan.
	c.	Employees should be trained to work in teams to solve problems and improve work systems.
	d.	Management should provide leadership in the quality initiative.
	e.	Work processes should be geared to specific customer needs.

5.	Communication systems and procedures should be provided to allow for frequent interaction between senior management and operating management.
	a.	Include managers operating from geographically removed locations.
	b.	Senior management should frequently visit decentralized operational sites.
	c.	Group or divisional management meetings should be held frequently.
	d.	Decentralized managers should visit central offices often enough to keep a broad organizational perspective.

6.	Analyze and identify senior management attitudes and actions toward financial reporting and disputes over accounting treatments, such as the following:
	a.	conservative vs. liberal accounting policies
	b.	whether or not accounting principles have been applied
		•	don't ignore signs of inappropriate practices
		•	be wary of estimates that "stretch the facts"
	c.	non-disclosure of important financial information
	d.	manipulated or falsified records

Organizational Structure

1.   Establish an appropriate, smooth flowing organizational structure.
     a.   The flow of work must facilitate management.
     b.   Direct the flow of activities as appropriate--upstream, downstream, or
          across all program activities.
     c.   Adjust the span of control for supervisors to an appropriate size for the
          supervisor, the activity, and the organization.

2.   Provide key managers with adequate, written, and understandable
     definitions of their responsibilities.
     a.   Clearly communicate responsibilities and expectations of program
          activities to the managers in charge of those activities.
     b.   Provide an organizational overview to managers at all levels, so they
          understand how their program activities tie into the goals and
          objectives of the entire organization.

3.   Periodically review the knowledge and experience of key managers related to
     their specific responsibilities.
     a.   Ascertain whether managers have the required experience, knowledge,
          and training to fulfill their responsibilities.
     b.   Encourage managers to update their management skills as their
          responsibilities change.

4.   Establish and maintain appropriate reporting relationships in the
     organization.
     a.   Analyze the need for dual or direct reporting relationships.
     b.   Monitor the effectiveness of existing relationships. Good reporting
          relationships provide managers with guidance appropriate to their
          responsibilities and authority.
     c.   Provide managers and supervisors with access to senior management.

5.   Periodically review and modify the organizational structure to match
     changing conditions. The organizational environment can be affected by
     changes in all the following areas:
     a.   political
     b.   regulatory
     c.   statutory
     d.   economic
     e.   technological
     f.   demographic

6.   Ascertain whether the organizational structure has sufficient numbers of
     employees in management and supervisory roles.

a. Managers and supervisors must have sufficient time to effectively carry out their responsibilities.
b. Establish controls to ensure employees work only as permitted under the Fair Labor Standards Act guidelines.

Risk Assessment

This component of internal control highlights the importance of management carefully identifying and evaluating factors that can preclude it from achieving its mission.

All departments encounter risks that threaten the achievement of their business objectives. Risks are introduced by numerous external and internal sources. Risk assessment is a systematic process for integrating professional judgement about probable adverse conditions and events, and assessing the likelihood of possible losses (financial and non-financial) resulting from their occurrence. Risks relate to both department-wide and activity level objectives.

Identifying and analyzing risks is a continuous process critical to maintaining effective internal control. The process for conducting a risk assessment provides a means for organizing and integrating professional judgement in meeting departmental objectives; a basis for risk management; and safeguards to be implemented. Risk assessment incorporates information from various sources, including discussions with management and staff.

The sections that follow explain how the risk assessment process involves establishing (or identifying) the department's mission and underlying objectives, then evaluating the related risks and methods for controlling them.

Department's Mission and Underlying Objectives
The COSO report states that, "Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent." In order to evaluate a department's success, a department must first determine whether its mission and objectives provide clear, well-defined targets for achievement.

Department mission statements are often derived from the State of Michigan constitution, enacted legislation, and directives issued by the Governor to affect ongoing operations. Related to these mission statements, departments can develop department-wide objectives and business strategies.

In Michigan State government, department-wide objectives reflect the high-level accomplishments a department is trying to achieve. These will also often provide the basis for how the department organizes its "activities" and conducts business. Department-wide objectives should also provide the basis for the establishment of well-defined, measurable goals for each of its primary activities.

The establishment of objectives allows departments to formulate critical success factors. These provide the measurement basis for determining if the

department, and the various managed activities, attains established objectives and goals. Critical success factors should be established at department-wide and activity levels (and can be established for each employee through the use of position descriptions and performance factors).

The following excerpt illustrates the mission statement and department-wide objectives established for one State department:

> *Mission*
> *The Michigan Department of Community Health (MDCH) strives for a healthier Michigan. To that end, the department will:*
>
> - *promote access to the broadest possible range of quality services and supports;*
>
> - *take steps to prevent disease, promote wellness and improve quality of life; and*
>
> - *strive for the delivery of those services and supports in a fiscally prudent manner.*
>
> *Department-wide objectives*
> *MDCH is responsible for health policy and management of Michigan's publicly-funded health service systems. Services are planned and delivered through these integrated components:*
>
> - *Medicaid health care coverage for people with limited incomes.*
> - *Mental health services for people who have a mental illness or a developmental disability, and services for people who need care for substance abuse.*
> - *Health needs assessment, health promotion, disease prevention, and accessibility to appropriate health care for all citizens.*
> - *Drug law enforcement, treatment, education and prevention programs.*
> - *Promoting independence and enhancing the dignity of Michigan's older persons and their families.*
> - *Administering the crime victims rights fund, investigating and processing crime victim compensation, and administering federal Victims of Crime Act grants.*

Even though each department has a unique mission and related objectives, all objectives relate to the desired performance in attaining the objectives of internal control (i.e., efficiency of operations, reliable financial reports, and compliance with laws, rules and regulations).

To be effective and ensure positive results, objectives must be **measurable, complementary and linked.** "Measurable" objectives allow management to determine, with reasonable precision, how well the department and its activities achieve their objectives. Measurable objectives are a fundamental requirement for most quality initiatives. Departmental objectives should be "complementary

and linked" within the department, in relation to the mission and underlying department-wide and activity level objectives. This helps to ensure that department-wide objectives are consistent with departmental capabilities and the objectives of its organized activities.

Evaluating Risks

The process for identifying and analyzing risk should be incorporate into a department's normal operations to ensure it is conducted as an ongoing process.

Risk Identification

Management should perform a comprehensive analysis of identifiable risks, including all risks associated with department-wide and activity level objectives (derived from the organization's mission). The activities analyzed should include those that support both financial and non-financial objectives. Management must consider the significant interactions with external organizations as well as those internal to their organization at both the department-wide and activity levels. Several means of risk identification can be used, including:

- Management planning conferences
- Periodic reviews of factors affecting the department's activities
- Qualitative or quantitative methods to identifying and prioritizing control efforts over high-risk activities
- Short and long-range forecasting
- Strategic planning

Management must consider external factors that may present risks to the agency, including:

- Business, political, and economic changes
- Changing needs or expectations of agency officials or the public
- Natural catastrophes
- New legislation or regulations
- Technological developments

Internal factors with inherent risks, include:

- Changes in management responsibilities
- Disruption of information systems processing
- Downsizing department operations
- Early retirements that reduce the workforce and knowledge base
- Highly decentralized program operations
- Management and employee accessibility to assets
- Nature of departmental activities and degree of centralization
- Quality of personnel and training provided
- Re-engineering agency operating processes

To identify risks, management must consider factors that may contribute to, or increase risk to which the department may be exposed. Factors to consider include past failures to meet budget limits and agency objectives; improper program expenditures; geographically distributed agency activities; and the significance and complexity of specific activities the agency undertakes. To ensure all risks are identified, the process for risk identification should be kept separate from analyzing the significance of risks.

Risk Analysis
After identifying department-wide and activity level risks, management should perform a risk analysis. The methodology may vary since risks are difficult to quantify; however, the process generally includes the following:

- Estimating risk significance
- Assessing likelihood/frequency of occurrence
- Considering how to manage risk

Risks with little significance and low probability of occurrence may require no action while those with high significance and frequency require special attention. After assessing the significance and likelihood of risk, management must determine how to control it. Approaches may differ among agencies, but they must be designed to maintain risk within levels deemed appropriate by management, considering the concepts of reasonable assurance and cost-benefit. Once implemented, the approach should be continually monitored for effectiveness.

Risk Management
Economic, regulatory, operational, and other conditions continuously change. Therefore, a mechanism must be devised to identify and manage the risks associated with change. Such analysis includes identifying potential causes for achieving or failing to achieve objectives; assessing the likelihood that such causes will occur; evaluating probable effects on achieving objectives; and considering the degree to which risks can be controlled.

Further, management must continually anticipate the occurrence of new risks resulting from change. This allows the implementation of control techniques during the development stages of new or changed processes.

Changing conditions that warrant special consideration with regard to risk include the following:

- Acceptance of audit findings and corrective action taken
- Complexity or volatility of activities
- Geographical dispersion of operations

- High personnel turnover
- Implementation of major new technologies, including information systems
- Management's judgements and accounting estimates
- New personnel in key positions
- Organizational, operational, or economic changes
- Personnel competence, adequacy, and integrity
- Rapid growth, expansion or downsizing
- Restructuring or reengineering
- New laws, rules and regulations

To determine the relative significance of changes, management may weigh the risk factors. This reflects management's judgement on relative impact, when selecting an activity for evaluation.

Implementation and Evaluation Guidance:

Establishment of Department-wide Objectives

1. Establish department-wide objectives specific enough for your department to fulfill its statutory responsibilities and desired results.

2. Periodically evaluate and update established objectives.

3. Communicate department-wide objectives to all involved in the process of achieving those objectives, including all employees of the department and oversight entities.

4. Link strategic plans to department-wide objectives.
   a. Strategic plans should support the department-wide objectives.
   b. Plans should address high-level resource allocations and priorities.
   c. Plans should contain realistic time frames and clearly defined roles and responsibilities.

5. Compare business plans and budget proposals with the following:
   a. Department-wide objectives- Plans and budgets should have appropriate detail for each level of management.
   b. Strategic plans- Budget proposals should be driven by the department's strategic plan.
   c. Current conditions- Plans and budget proposals should reflect your department's historical experience and current conditions.

Establishment of Activity-level Objectives

1.   Establish activity level objectives, with participation of management at every
      level within the department.
      a.   Managers should establish activity level objectives for which they are
            responsible.
            • Managers must support the objectives.
            • Managers must be committed to achieving the objectives.
      b.   Activity-level objectives must be measurable.
            • Include measurement criteria.
            • Measurements should be quantifiable.
      c.   Establish a process for reconciling inconsistent objectives.
            • Objectives should be complementary and reinforcing *within* each
              activity.
            • Objectives should be complementary and reinforcing *between*
              activities.
      d.   Identify resources needed to achieve the activity level objectives.
            • Make plans for acquiring necessary resources, such as
              appropriations, personnel, facilities, and technology.
            • Link identified resource needs to the budgeting process.

2.   Link activity level objectives with department-wide objectives and strategic
      plans.
      a.   Identify all significant activities and their objectives.
            • Identify activity level objectives critical to success of the
              department.
            • Consider where failure must be avoided to achieve those critical
              activity level objectives.
      b.   Make sure every identified activity is linked to department-wide
            objectives. Ascertain whether budgets are based on relative
            importance of activity level objectives.
      c.   Periodically review activity level objectives for continued relevance, in
            light of department-wide objectives.

Managing and Evaluating Risks-Risk Identification and Analysis

1.   Establish a risk identification and risk assessment plan for the entire
      department.
      a.   Involve the appropriate managers and staff at all activity levels.
      b.   Include methods for identifying risks arising from external sources,
            including the following:
            • economic conditions
            • social conditions
            • political conditions
            • external regulation
            • natural events
            • potential competitors' actions

- supply sources
- technology changes

c.   Include methods for identifying risks arising from internal sources, including the following:
- changes in personnel duties (such as the retention of key management personnel or changes in responsibilities which could affect the ability of employees to function effectively)
- appropriation requests (such as the availability of funds for new initiatives or continuation of key programs)
- employee relations (such as compensation and benefit programs)
- information systems (such as adequate backup systems, in case systems fail and significantly affect operations)
- data processing (such as disclosure of data, data integrity, and error, fraud, or misuse of data)
- cash management activities
- asset protection and preservation

d.   Schedule periodic re-evaluations of risk.
- external
- internal

e.   Establish risk-analysis processes and guidelines.
- Consider a formal process, to include the following:
    - estimate significance of risk
    - assess likelihood of risk occurring
    - determine needed actions
- Include informal, day-to-day management activities in the process.

Managing and Evaluating Risks Related to Change

1.   Establish plans and procedures for managing change, considering the following suggestions:

a.   Routine changes can be addressed as part of the normal risk identification and analysis process discussed above, or it can be a separate process.
- Establish ways to anticipate, identify, and react to routine events affecting the ability of the department to achieve its objectives.
- Involve managers most responsible for the affected activities.
- All employees should be encouraged to identify and communicate changing conditions or events.

b.   Risks and opportunities related to change should be addressed at sufficiently high levels in the department to allow for identification of their full implications and for formulation of appropriate action plans.
- All affected activities within the department should be brought into the review process.

2. Include mechanisms to identify and react to dramatic changes possibly having a pervasive effect on the department, demanding attention from top management. Consider the following:

a. Changed operating environment
- External information may reveal major shifts in customer needs or public perception.
- Significant shifts in the work force, externally or internally, could affect available skill levels.
- New legislation or Executive Orders could have dramatic implications on the department.

b. New or redesigned information systems
- The effects of new systems may need to be assessed.
- Appropriateness of existing control activities should be considered before new computer systems are developed and implemented.
- Systems development and implementation policies must be adhered to, despite pressures to "shortcut" the process.
- Consider the effect of new systems on information flow and related controls.
- Consider the effect of new systems on employee training and employee resistance to change.

c. New personnel
- Take special action to ensure new personnel understand the departmental.
- Consider key control activities performed by personnel being promoted or transferred.

d. New services, products, activities, and acquisitions
- Strive to reasonably forecast operating and financial results.
- Implement adequate information systems and control activities for a new service, product, or activity.
- Develop plans for recruiting and training people with the requisite expertise to deal with new services or activities.
- Establish procedures for tracking early results and for modifying processes as needed.
- Monitor the effects on other departmental programs or activities.

e. Departmental restructuring or reductions
- Analyze staff reassignments or reductions for their potential effect on related operations.
- Reassign the control responsibilities of employees who are transferred or terminated.

- Consider the impact on the morale of remaining employees after a major downsizing has occurred.
- Take steps to minimize disruption to essential or continuing services.
- Develop plans for preventing dislocated workers from disrupting service or destroying records.

f.   Decentralized operations
- Senior management should keep abreast of the political, regulatory, business, and social cultures of areas where decentralized operations occur.
- All decentralized operations personnel must be made aware of accepted norms and rules of the department's central office.
- Establish alternative procedures in case activities or communications of decentralized operations are interrupted.

g.   New technology
- Obtain information on technological developments through reporting services, consultants, seminars, or public/private sector alliances.
- Monitor new technologies and applications.
- Develop mechanisms for taking advantage of and controlling use of new technology applications and for incorporating them into work processes or information systems.

h.   Rapid growth
- Information system capabilities should be upgraded to process rapidly increasing volumes of information.
- The work force in operations, accounting, and information systems should be expanded as needed, to keep pace with increased volume.
- Establish procedures and processes for revising budgets and forecasts, as needed.
- Establish a process for considering departmental implications when objectives and plans are revised by the information systems component of the department.

Control Activities

Control activities occur at all levels and in all activities of the department. Examples of control activities include: policies and procedures; organizational plans; managerial approvals and authorizations; verifications and reconciliation; performance reviews; security maintenance; restrictions on access to resources;

segregation of duties; documentation of transactions and event cycles by means of flowcharts and narratives.

Control activities are implemented to ensure that management's directives are followed, which in turn reduces risks and contributes toward the achievement of department objectives.

Since a system of internal controls is integrated into the day-to-day operations of each department, the system needs to react to changing conditions. The need for changes in the system of internal controls can be either one that is proactive or reactive. Proactive changes result from incorporating internal control techniques at the front-end of department-wide programs and process changes. Management should maintain the capability to react timely and implement needed changes that are identified during the performance of ongoing monitoring procedures (as well as separate/periodic internal control evaluations).

Types of Control Activities
Control activities include preventive, detective, and corrective controls. The following categories of control activities are common to all departments:

Policies and Procedures: Documented policies and procedures should clearly indicate the actions and responsibilities of all employees relative to performance of job responsibilities. Management should formally approve these with regular updates on changes that may have occurred.

Review of Performance by Management: All levels of department managers should review performance reports, analyze trends, and relate results to targeted and historical performance. The accuracy of operational summaries should also be verified.

Reconciliation: Managers should periodically reconcile summary information to supporting detail.

Physical Control: Equipment, inventories, securities, cash, and other assets vulnerable to risk of loss or unauthorized use, must be physically secured, periodically counted, and compared to amounts shown on control records.

Performance Indicators: Control activities must be established to monitor performance indicators. This control requires comparisons and assessments relating different sets of data to one another for analysis of relationships and appropriate corrective action. Management should investigate unexpected results, unusual trends, or conditions that may prevent the organization from achieving its business objectives.

Information Processing: Several control activities may be used to verify data accuracy, completeness, and appropriate authorization of transactions. Control activities for information processing include procedures to ensure that:

- data entered into systems is subjected to edit checks and matched to approved control files,
- transactions are accounted for in numeric sequence,
- file totals are compared with control accounts,
- exceptions are examined and acted upon, and
- access to data, operating system, and program files (source and object code) is granted to only authorized individuals.

Segregation of Duties: Duties and responsibilities should be divided among staff to reduce the risk of errors, waste, misuse, or fraud. No one individual should control all key aspects of a transaction or event.

Integration with Risk Assessment
Implementation of control activities results from an effective risk assessment process. Control activities should be understood and valued as the primary means by which a department can achieve its stated mission. This requires a seamless integration of control activities "built into" the overall department infrastructure and its management process.

Controls over Information Systems
The use of computer systems to process information fundamentally affects the types of internal control techniques employed, but not management's responsibility to maintain effective internal control. These differences flow from characteristics, which distinguish computer-based from manual processing procedures. Controls over information system processing are separated into two broad groupings of controls - **general controls** and **application controls.**

General Controls
These concern all control activities that provide for the proper operation of many, if not all, application systems. They may include controls over developing, modifying, maintaining computer programs, and use of and changes to data stored on computer files. General controls encompass the following:

- Strategic planning
- Business continuity and contingency planning
- Systems development methodology
- Plan of organization and operation of computer activity

- Procedures for documenting, reviewing, testing, approving, and changing systems or programs
- Controls built into equipment by the manufacturer (hardware controls)
- Controls over access to equipment and data files

Application Controls
Application controls include computerized and manual controls used to ensure completeness, accuracy, and validity of information processed by each respective application system. They include the following categories:

- Input controls:
  Internal control techniques to provide reasonable assurance that data is identified, converted into machine-readable format, and properly authorized. Input control procedures assure that data transmitted over communication lines has not been lost, suppressed, added, duplicated, or otherwise improperly changed, and that rejected (in error) transactions are identified, corrected, and resubmitted for proper processing.

- Processing controls:
  Internal control techniques to provide reasonable assurance that only authorized transactions are processed as intended for the particular application; that transactions are complete, accurate and timely; that unauthorized transactions, or those containing errors, are identified for follow-up action.

- Output controls:
  Internal control techniques to provide assurance that processing results are accurate and distributed to only authorized personnel. These techniques may include account lists, displays, reports, magnetic files, invoices, disbursement checks, etc.

Relationship between General and Application Controls
General and application controls over information systems are interrelated. If general controls are inadequate, application controls are unlikely to function properly and can be overridden. Application controls assume that general controls will function properly and provide immediate feedback on errors, mismatches, incorrect data format or inappropriate data access. The relationship between general controls and application controls is such that general controls are needed to support the functioning of application controls. Both are needed to ensure complete and accurate information processing.

Evolving Issues for Controlling Information Technology
The field of information processing is one of rapid technological change. New technologies include increased use of electronic commerce, self-service solutions, end-user computing, and other forms of distributed processing – many of these technologies are the result of advanced networking capabilities, such as the Internet. Management can expect that new technologies will continually emerge at a rapid pace.

Equally important is the need for management to understand that new technology affects how controls are implemented, but they do not change the basic requirements for internal control. Management must continually research and make efficient and effective use of new technologies, but at the same time it must design and implement accompanying control activities that contribute toward the achievement of its primary business objectives.

Control Objectives for Information and Related Technology (COBIT)
In April 1996, the Information Systems Audit and Control Foundation (ISACF) developed an internal control framework to manage, use, and audit information technology. The framework (referred to as COBIT) consists of 34 high-level **control objectives** associated with primary information technology processes, grouped into four domains. The four domains are planning and organization, acquisition and implementation, delivery and support, and monitoring.

The basic philosophy of the COBIT framework is to center the need for internal controls over information technology processes according to a natural grouping of common information technology processes. The framework is based on the concept that management must first achieve a complete understanding of the department's business processes before it can effectively develop, manage, and audit the processes for implementing information and related technology solutions. The framework is based on the underlying the assumption that a department's core business processes drive the need for implementing information and related technology. Control objectives define the criteria that must be met to ensure delivery of technology solutions that meet the department's business requirements.

It must be noted that the control objectives summarized in the COBIT control framework are not categorized as general and application controls. However, each of the control objectives relates to processes and underlying control techniques that can be

categorized as either general or application controls, or a combination of both.

Management, together with internal auditors, should consider use of the COBIT control framework, as it closely aligns with the COSO control framework. It offers management and internal auditors a framework to build and maintain quality systems, but also serves as the criteria for evaluating management's performance at efficiently building quality systems to support departmental business requirements.

Department-Specific Control Activities
Specific internal control activities implemented by one agency will often differ from those used by other agencies. These differences are typically related to varying business objectives; managerial judgement; complexity of the organization; operational environment; sensitivity of data; and special legal requirements. These factors must be considered when designing control activities that are most appropriate for an agency.

Documentation
Internal controls must be documented as required by the Management and Budget Act. The Act states, "Each head of a principal department shall **document the system....**". Documentation may include a formal set of policies and procedures, as well as flow charts (both process flows and information system flows), organizational charts, and job descriptions.

Adequate documentation makes dissemination of system requirements to employees more effective (see section on information and communication). Documentation enhances management's ability to monitor controls, identify deficiencies, and initiate corrective actions to enhance the system. Proper documentation makes the evaluation of the system much more efficient. Management, as well as internal and external auditors can realize this efficiency, as they will not have to "reinvent the wheel" every time they conduct periodic evaluations.

Documentation of the internal control structure should illustrate how control activities work to minimize the risk towards achievement of department-wide and activity level objectives. As the departments within Michigan State government consist of numerous business processes, documenting the internal control structure (in terms of objectives, risks, and control activities) is vital to ensuring proper controls are maintained.

Finally, the COSO report notes that, "The nature and extent of documentation will become more substantive when statements about the system or evaluation are made to additional parties." As noted in the System

of Reporting section of this document, the information summarized in a department's evaluation of internal controls is not just for internal purposes. The Management and Budget Act requires reporting to the Governor, Legislature, Auditor General, and DMB.

Implementation and Evaluation Guidance:

1.   Develop control activities or technologies to minimize risk.
    a.   Identify significant risk areas and establish control mechanisms to prevent or minimize errors.
    b.   Perform cost/benefit analysis on control mechanisms to ensure cost effectiveness.
    c.   Periodically review control activities to determine whether they should be updated.

2.   Establish appropriate written policies and procedures for your department's key activities.
    a.   Maintain current policies and procedures manuals.
    b.   Provide employees with access to those procedures related to their jobs.
    c.   Train new employees in the use of policies and procedures manuals.

3.   Actively apply identified control activities.
    a.   Controls described in the internal control policy manual should be properly applied to the related activity.
    b.   Appropriate and timely action should be taken on information or exceptions requiring follow-up.
    c.   Supervisory personnel should test the ongoing effectiveness of controls.
    d.   Management should periodically review controls to assess their validity.

Information and Communication

Each department must capture pertinent financial and non-financial information relating to external and internal activities. This information must be identified as relevant to managing the agency and communicated to those who need it. Communication should be in a form and time frame that enables all employees to carry out their control responsibilities.

Factors management should consider in establishing internal controls related to information and communication are described below.

Information
Pertinent information must be identified, captured, and communicated in a form and time frame that permits users to perform their duties efficiently. Information systems produce data that enables control of relevant information flowing down, across, and up the organization. Management must clearly communicate to all employees that control responsibility is critical. Employees must understand their role in internal control and have a means of communicating critical information to management. There must also be effective communication lines with external customers, contractors, suppliers, and regulators.

Information systems support the achievement of all three categories of internal control objectives – operational efficiency, reliable financial reporting, and compliance with laws, rules, and regulations. Information systems should be effectively integrated with and support departmental business objectives. Therefore, decisions on continued investment in technology, either enhancement to existing systems or development of new systems, should be considered during a department's development of long-term and short-term business strategies.

Management will often need to resist assuming that investing in the "latest and greatest" technology will always increase the department's success in achieving its objectives. Existing systems are often reliable because they have been "molded" over many years to most effectively support departmental business objectives. Conversely, the cost of investing in frequent enhancements to existing systems may diminish the relative value provided by them.

When technology investment decisions are integrated into the development of departmental business strategies, management increases its ability to maintain systems that produce relevant and quality information that support achievement of the organization's mission. This is a key concept embodied in the COBIT control framework (COBIT is discussed in the Control Activities section).

The appropriateness of content, timeliness, accuracy, and accessibility of information are attributes with which to measure information quality. Quality factors are affected by internal control and must be inherent in the information to ensure that informed decisions are made throughout the department.

Communication

Information systems inherently imply communications. Information must be captured and promptly provided to appropriate personnel, so they can perform their operating, financial reporting, and compliance responsibilities. Information must be communicated internally and externally to other appropriate groups.

Internal Communication

Internal communication is important for effective internal control. To ensure that effective internal communication occurs, the following types of control should be in place:

- Management must provide a clear message to all personnel that internal control responsibilities are critically important.

- Employees must understand their specific duties, aspects of internal control, and their role in it. They should know how their work relates to the work of others, which may help to address problem recognition, causes, and corrective action. Any uncertainty the employee has should be clarified.

- Personnel should demonstrate acceptable behavior.

- Personnel need a means of communicating information upward within the agency. Management must open lines of communication and display a willingness to listen. Separate lines of communication may be necessary if normal channels prove ineffective.

- Personnel must know that there will be no reprisal for reporting information.

- Management must update internal oversight groups regarding performance, developments, risks, major initiatives, and other significant or relevant events.

External Communication

Agencies communicate with various external groups that may have an impact on the operations and activities of the department. To ensure effective external communications, management should provide for open lines of communications with contractors, suppliers, and other customers of the agency. These groups provide significant feedback regarding the quality and design of agency business processes and supporting activities.

Means of Communication

Formal and informal communications include policies, procedures, meetings, memoranda, bulletin board messages, e-mails, speeches, etc.

However, the most powerful form of communication is often the action taken by management regarding personnel and the support it demonstrates toward them.

Communicating Internal Control Requirements
The Management and Budget Act requires that, "Each head of a principal department shall…**communicate system requirements to employees of that principal department….**".

Communicating internal controls is an implicit part of every employee's position description. Each employee is involved in at least one process or activity; therefore, they are part of an overall system of internal controls. As such, they must be made aware of the requirements of the system of internal controls and informed of any changes to the requirements.

To accomplish timely and effective communication about the requirements of internal control, management should maintain thorough documentation of the internal control structure. With this, employees understand their internal control responsibilities and can better communicate system-related problems. System requirements, and changes to those requirements, can be disseminated in a variety of ways - memorandums, bulletin boards, e-mails, policy and procedure manuals, and the use of internet and/or intranet sites.

Implementation and Evaluation Guidance:

Information

1.   Establish procedures to provide management with external and internal information needed for evaluation of the department's performance in relation to established objectives.
     a.   Obtain relevant external information on legislative or regulatory developments and on economic and social changes.
     b.   Regularly identify and report information useful for evaluating achievement of critical objectives.
     c.   Provide managers information they need to carry out their responsibilities, including the following:
          - analytical information enabling managers to develop plans of action
          - information at the right level of detail for the varying levels of management
          - information summaries, supported by available pertinent facts and details, as needed for further examination

- timely information for management to effectively monitor events and activities (internal or external) and the ability to react to economic and social factors and control issues
  d. Develop and revise information systems based on overall strategic plan.
    - Link systems to department-wide objectives.
    - Link systems to activity level objectives.
    - Consider establishing an information-technology steering committee to identify emerging information needs.
    - Information needs and priorities should be determined by management with sufficiently broad responsibilities.
    - Develop a long-range information-technology plan linked with the strategic objectives.

2. Make a firm management commitment to supporting the development of necessary information systems.
  a. Commit appropriate human and financial resources.
    - Managers, analysts, or programmers with requisite technical ability must be available to develop new or enhanced information systems.
    - Employees need to be adequately trained in new or enhanced information systems.
    - Information systems staff should provide training and support services to other employees, as needed.

Communication

1. Establish procedures for effectively communicating to employees their duties and control responsibilities.
  a. Consider the following methods:
    - formal and informal training sessions
    - employee evaluation meetings
    - on-the-job communication
  b. Employees should know the objectives of their activities and how their duties contribute to achieving those objectives.
  c. Employees should understand how their duties impact other employees and how the duties of other employees impact them.
  d. Employees should understand how their work contributes to larger process and departmental goals.

2. Establish channels of communication for employees to report suspected improprieties, as follows:
  a. respecting anonymity and confidentiality
  b. making employees feel comfortable using the channels, when necessary

c. providing feedback and immunity from reprisal to employees who report suspected improprieties

3. Establish an employee suggestion process.
   a. Emphasize quality improvement recommendations.
   b. Acknowledge good employee suggestions with meaningful rewards and recognition.

4. Establish procedures for adequate intra-department communication, enabling employees to effectively perform their jobs.
   a. Give employees sufficient and timely information.
   b. Share and disseminate central management's internal and external information.
   c. Hold regular staff meetings.
   d. Circulate departmental newsletters.
   e. Disseminate new policies and procedures.
   f. Routinely communicate changes in legislation.
   g. Notify staff of management activities, including the following:
      • long-range objectives
      • departmental changes
      • departmental and staff achievements

5. Establish open and effective channels of communication with customers, suppliers, and other external parties regarding changing customer needs.
   a. Provide channels for feedback among all pertinent parties.
   b. Notify customers and constituencies of your department's services and products.
   c. Advertise your agency's "services" to target populations.
   d. Capture suggestions (and complaints) and inform all relevant internal parties.
   e. Take appropriate follow-up actions on suggestions (and complaints); provide customer feedback.
   f. Ensure employees can identify the customers of their key work processes.
   g. Periodically survey customers to evaluate how their needs and expectations are being met.

6. Communicate your organization's ethical standards to customers and constituencies.
   a. Notify suppliers, customers, and others of the standards and expectations regarding their dealings with your department.
   b. Reinforce standards, by example, in routine dealings with external parties.
   c. Report to appropriate personnel improprieties by employees of external entities.

7. Establish policies and procedures to ensure timely and appropriate follow-up on communication received from customers, vendors, regulators, and other external entities.
   a. Present a receptive attitude to reported problems with products, services, and other matters.
   b. Correct errors in customer billings in a timely manner and initiate improvements to processes to avoid repeat errors.
   c. Involve appropriate personnel when processing complaints.
   d. Take appropriate action and provide follow-up communication to original sources.
   e. Provide methods for notifying top management of the nature and volume of complaints.

Monitoring

This component involves assessing the quality of internal controls. It involves assessments by appropriate personnel, of the design and operation of controls, noting any deficiencies, and putting into place appropriate corrective actions. The Management and Budget Act requires that "Each head of a principal department shall…**assure that the system is functioning as prescribed, and modify as appropriate for changes in condition of the system."**

A system of internal control must be integrated into the everyday operations of each department. To maintain ongoing assurances about the continued effectiveness of the internal control structure, management must continually monitor the system to identify the need for changes.

Although management (and internal auditors) maintains primary responsibility for monitoring the system of internal controls, non-managerial employees are also important to monitoring the system on a daily basis; they are often closest to the operations and, therefore, are in the best position to determine where processes (and related controls) can be improved.

Types of Monitoring
Monitoring includes management reviews, comparisons, reconciliation procedures, and other duties performed by departmental employees. Monitoring activities can be categorized into ongoing and separate periodic evaluations. Effective ongoing monitoring activities will often require less need for separate evaluations.

Ongoing Monitoring Activities
These activities, performed continuously, are integrated into the department's normal operations and are often more effective than separate evaluations. Numerous types of activities may be used to monitor internal control on an ongoing basis. Activities that can be incorporated into agency internal controls include procedures to determine:

- the extent to which personnel, in carrying out their activities, obtain evidence as to whether the system of internal control is working properly

- the extent to which communications from external parties corroborate internally generated information

- whether assets recorded on the accounting system agree with assets on-hand

- the extent to which employees are responsive to internal and external auditor recommendations

- the extent to which employees clearly understand and comply with the department's code of conduct

Separate Evaluations

While ongoing monitoring activities provide important feedback on the effectiveness of internal controls, separate evaluations can be useful by focusing directly on the effectiveness of controls at specified points in time.

Scope and Frequency

Evaluations of internal control vary in scope and frequency. The frequency and scope of evaluations is a matter of judgement. Management must have reasonable assurance on the effectiveness of internal controls. Judgement takes into account the significance of risks being controlled and importance of controls in reducing those risks.

When evaluating the internal control system, attention must be directed to each internal control component, with respect to all significant activities. The scope of an evaluation depends upon which category of internal control objectives – operations, financial reporting, or compliance – will be addressed.

Evaluators

Those responsible for a specific process or function must determine the effectiveness of controls for their activities. In addition, internal auditors should evaluate internal controls as part of their normal duties or upon management request. Management may employ a combination of methods and may utilize the services of external auditors.

Process

Evaluating internal controls is a process in itself. While approaches and techniques vary among departments, there must be a discipline within the process with basic concepts. Evaluators must understand the department's core business processes and the components of internal control being addressed and must determine how a system works in comparison to how it was intended to work; recognize procedures requiring modification (or obsolescence); analyze internal controls and test them against established criteria; evaluate test results and determine if controls provide reasonable assurance towards accomplishment of the stated objectives.

Evaluation Methods
Many types of evaluation methodologies and tools are available (e.g., check lists, questionnaires, flowcharts, quantitative techniques, lists of control objectives, and direct tests of control effectiveness). Evaluators must use methods most appropriate to the circumstances relevant to their department. Benchmarking against other agencies, non-governmental entities, and trade or association standards may be used. Management consultants can provide comparative information while peer reviews may also be useful in evaluating control systems.

Testing Internal Controls
An important part of any evaluation activity is testing the reliability of internal control procedures. Testing can be done (on an ongoing or periodic basis) by reviewing transactions, performance reports, and supporting documentation for program activities. Additional tests may include making inquiries of appropriate personnel; observing how separation of duties and similar control-related activities are carried out; and personally re-performing selected control activities to verify results.

The results of these tests should be reviewed and evaluated by management to assess the significance of any errors or deficiencies. Corrective action plans should be established (and monitored) to ensure that errors and deficiencies are addressed.

Implementation and Evaluation Guidance:

On-going Monitoring

1.   Establish policies and procedures to enable management to monitor the reliability of reporting systems.
      a.   Periodically review reports to ensure that data is accurate, reliable, and measuring the right things.
      b.   Integrate or reconcile information used to manage operations with data generated by the financial reporting system.
      c.   Require operating personnel to be accountable for the accuracy of their unit's financial reports.

2.   Establish policies and procedures to ensure employees obtain evidence about the proper design and functioning of the internal control structure, as they carry out their regular activities.
      a.   Provide copies of internal audits and other internal control system evaluation reports to employees.
      b.   Involve employees in the creation and evaluation of internal control systems.

3. Establish procedures to monitor the extent to which communications from external parties corroborate internally generated information, or indicate internal control problems.

   a. Customers implicitly corroborate billing data by paying their invoices or fees.
      - Investigate customer complaints about billings or fees when system deficiencies in the invoicing process are indicated.
      - Investigate the validity and cause of complaints from regulated entities or benefits recipients.

   b. Use communications from vendors and monthly statements of accounts payable as a control monitoring technique.
      - Fully investigate suppliers' complaints of unfair practices by purchasing agents.
      - Encourage feedback from regulators and central control agencies regarding matters related to your department's internal control system.
      - Reassess controls that should have prevented or detected problems.

   c. Be responsive to internal and external auditor recommendations on ways to strengthen internal controls.

   d. Seek feedback at staff meetings, planning sessions, and other meetings on whether controls are operating effectively.

   e. Actively monitor staff who regularly perform critical activities.
      - Require employees to sign logs or other evidence they have performed critical control functions (such as reconciling specific amounts).
      - Periodically review critical control activities with the employees responsible for them, to ensure they are still applicable and are working properly.
      - Periodically have personnel state whether they understand and comply with codes of conduct.
      - Solicit suggestions from employees for improving or changing control activities.

   f. Periodically review the effectiveness of internal audit activities.
      - Appropriate levels of competent and experienced staff are essential.
      - Internal auditors must have appropriately independent positions in the department organizational structure.
      - Internal auditors should have access to senior executives.
      - Internal auditors' plans, scope, and responsibilities must be appropriate to departmental needs.

Separate Evaluations

1.   Develop a plan for systematic separate evaluations of the internal control system.
    a.   Include all appropriate portions of the internal control system.
        - The evaluation team should plan the evaluation process to ensure a coordinated effort.
        - A manager with requisite authority should conduct the evaluation process.
    b.   Personnel with requisite skills should conduct evaluations.
        - Evaluators must have or gain sufficient understanding of the department's activities.
        - Evaluation methods should include checklists, questionnaires, or other tools.
    c.   Ascertain whether evaluations have adequate scope, depth of coverage, and frequency.
        - You should have an understanding of how the system is *supposed* to work.
        - You should gain an understanding of how the system *actually is* working.
    d.   Make policy manuals, organizational charts, operating instructions, etc., readily available to the evaluation team.
    e.   Document the evaluation process.
    f.   Measure the evaluation results against pre-established criteria.

Reporting Strengths and Weaknesses

1.   Develop mechanisms for capturing and reporting identified internal control strengths and weaknesses.
    a.   Formal evaluations by both internal and external parties should be reported to management.
    b.   Findings from ongoing monitoring or separate evaluations should be reported to management.
    c.   Deficiencies should be reported to the person directly responsible for the activity as well as to senior management.
2.   Develop processes to ensure appropriate follow-up actions are taken on weaknesses.

Planning and Conducting an Evaluation of Internal Controls

Requirements for Maintaining Internal Control

The Management and Budget Act requires department directors to establish and continually maintain an effective internal control structure. The following are applicable excerpts from the Act:

- *"Each head of a principal department shall **document** the system, **communicate** system requirements to employees of that principal department, **assure** that the system is functioning as prescribed, and **modify** as appropriate for changes in condition of the system."*

- *"… biennially… the head of each principal department shall provide a report …on the evaluation of the principal department's internal accounting and administrative control system…"*

- *"The report shall include… a description of any material inadequacy or weakness discovered in connection with the evaluation of the department's internal accounting and administrative control system as of October 1 of the preceding year and the plans and a time schedule for correcting the internal accounting and administrative control system, described in detail."*

To comply with these requirements, department directors must recognize that an internal control structure is not a separate system within a department, but rather is an integral part of departmental operations. Furthermore, senior management is responsible for *monitoring* the ongoing effectiveness of internal controls to assure that they are functioning as intended.

According to the COSO report, the monitoring component of the internal control structure "assesses the quality of internal controls over time" through the performance of ongoing monitoring activities **and** separate evaluations. The scope and frequency of separate evaluations is a matter of professional judgement that depends heavily on departments' ongoing assessment of risks and the effectiveness of ongoing monitoring procedures.

It is likely impractical to conduct comprehensive, separate evaluations of all departmental activities at the close of every biennial period. Furthermore, some departmental activities may not require separate evaluations as frequent as every two years.

Instead, the head of each department should implement an overall monitoring plan, consisting of both ongoing monitoring activities and separate evaluations, that will provide reasonable assurance **at any point in time** about the effectiveness of the

internal control structure.   By doing this, management should strive to spread evaluation efforts throughout the entire biennial period, conducting specific department-wide evaluative efforts at the close of each biennial period.

To implement an overall monitoring plan, departments should conduct necessary separate evaluations, focused at both ***department-wide*** objectives and ***"activity"*** level objectives. Department-wide objectives should be linked and integrated with more specific objectives established for departmental activities. Activities are defined below in the section entitled "Segmenting the Department."

The ***department-wide evaluation*** should provide the department director and senior leadership with overall conclusions that the department's internal control structure provides reasonable assurance that measures are in place to achieve department-wide objectives and the objectives of internal control. Senior management should utilize the results of activity level monitoring to formulate conclusions about the department's internal control structure – however, additional work may be required to evaluate certain risks that are controlled from a centralized perspective. For example, activity level management may not be concerned that all departmental objectives are consistent and interrelated.

Activity level evaluations should be conducted as frequently as required to allow respective activity manager(s) to have reasonable assurance about the ongoing effectiveness of the internal control structure for the activity being evaluated. In activity level (as well as department-wide) evaluations, management personnel is responsible for determining the effectiveness of the five components of internal control that allow for achievement of the objectives that the activity (or department) is trying to accomplish.

The recommended approach for departments to comply with the "biennial" evaluation requirements (set forth in the Management and Budget Act) includes the following steps:

1. Establish Leadership Responsibility
2. Segment the Department into Activities
3. Committing Staff Resources
4. Establish a System to Monitor Evaluation Efforts
5. Schedule the Evaluations
6. Conduct and Document Evaluation Efforts and Conclusions

Each step is discussed in the following sections.

Establishing Leadership Responsibility

It is unrealistic to expect a department head to have first-hand knowledge of the status of all segments of the department's internal control system, therefore, appropriate responsibilities should be carefully assigned to senior management of the department. Senior management is responsible to ensure that the process of evaluating, improving and reporting on internal controls is carried out and to provide the department head with written assurances that the responsibilities have been carried out.

Specific responsibilities for the department's evaluation efforts are discussed below.

Direction of the department-wide effort
A Designated Senior Official (DSO) should be responsible for coordinating the overall effort of evaluating, improving, and reporting on internal control in conformance with this general framework. This official should be asked to provide assurance that departmental evaluation processes have been conducted in accordance with the general framework, in a thorough and conscientious manner, and to decide as to which internal control weaknesses are material and should be reported for the department as a whole. This official is also responsible for segmenting the department into activities by which it achieves its mission, and department-wide and activity level objectives.

Managerial employees
The DSO should be assigned overall responsibility for the department's monitoring system. However, much of the departmental evaluation efforts should be assigned to departmental managers responsible for the various activities of the departments. "Activities" consist of a department's organizational component(s), programs, or administrative functions. In some instances, an activity may also correlate to a core business process that "cuts across" several organizational components. "Segmenting" is further described below.

Managers of departmental activities are responsible for maintaining and monitoring the effectiveness of internal controls in their area of responsibility. This is done on an ongoing basis to assure that the manager has reasonable assurance about the effectiveness of the internal control structure (over the respective activity) at any point in time.

The DSO should make significant use of evaluations conducted by activity managers in order to plan and execute the department-wide evaluation.

Internal Auditor
The internal auditor has been given a number of specific responsibilities per the Management and Budget Act. Some of those responsibilities are part of the internal auditor's day-to-day job duties, and some pertain specifically to the biennial evaluation process.

A large part of an internal auditor's day-to-day duties include performing internal control audits and reviews throughout the department. These and other activities are left to the internal auditor (and professional staff) to plan, schedule, and carry out. Guidelines for these activities are not presented in this document.

Regarding the biennial evaluation process, the internal auditor must conclude whether the evaluation process has been conducted in accordance with guidance provided in the general framework. The internal auditor's conclusions should be based on a review to determine whether the evaluation of internal control was carried out in a reasonable and prudent manner.

Reviews of biennial evaluation activities by the internal auditor should not preclude the internal auditor from providing technical assistance in the departmental effort to evaluate internal controls, or as otherwise limiting the authority and independence of the internal auditor. In fact, the internal auditor is encouraged to provide technical assistance during evaluation efforts to further the overall goal of strengthening the internal control structure.

It is imperative that management throughout the department is primarily responsible for conducting the evaluation, since it is management that has primary responsibility for the maintenance of a strong internal control structure. The internal auditor should not be considered the "risk manager" but rather as the professional who assists management to recognize, understand, and appropriately control risks.

Care should be taken to avoid duplication of work. To the extent that an internal auditor has conducted or is planning to conduct internal control reviews of certain agency activities, a determination should be made as to how these reviews can help accomplish the required evaluations. In those instances where the internal auditor agrees to conduct certain internal control reviews, the senior official designated to direct the department-wide effort might rely on the internal control reviews performed by the internal auditor.

Segmenting the Department into Activities

The evaluation approach recommended in this guidance is for the DSO to make all managers of departmental "activities" responsible for maintaining, monitoring and documenting the internal control structure for their respective area of responsibility. Related to this, monitoring should be carried out on an ongoing basis and integrated into the daily activities of management.

An activity may be defined as one or several organizational components that seek to achieve common business objectives. Alternatively, the activity may correlate with a core business process that "cuts across" several organizational components. Some

activities exist to support the achievement of objectives by other departmental activities, including administrative activities, human resources, and information technology.

There is no single method to segment a department into activities for purposes of evaluating the internal control structure, particularly since departments vary in organizational structure and nature of activities.   However, segmenting the department into manageable activities is a critical aspect of carrying out a department-wide evaluation in an efficient and effective manner.

Segmenting the department into activities allows the identification of and assignment of responsibility for maintaining effective internal controls throughout the organization.

Benefits of segmenting the department into primary activities include:

- It requires management to consciously identify critical activities that directly support the achievement of its mission and underlying department-wide objectives.

- It allows management to focus at all aspects of an activity or business process, from beginning to the end. In doing this, real problems, rather than symptoms, can be identified and corrected.

- It fosters collaboration of many employees, sometimes from different organizational components, to better understand the department's core business processes and their role in it. Business process improvements often result from these "business process oriented" evaluations.

- It yields more efficiency and effectiveness in evaluating the effectiveness of the department-wide internal control structure

To develop an inventory of primary activities, reference various sources of information including the department's budget (and related materials), organization charts, policy/procedure manuals, and management information systems. The following factors should also be considered:

- Existing reporting relationships in the organizational structure
- Nature and size of the department's activities
- Numbers of sub-activities in an activity
- Number of separate organizational components involved in managing an activity
- Degree of independence of the activity
- Differences in processes and systems used by the activity
- Degree of centralization or decentralization
- Budget levels and number of personnel

Each of these factors should be considered in relation to the overall mission and objectives of the department. Identification of risks and control activities for each primary activity should be directly linked to one or more of the department's overall objectives.

The degrees of independence and centralization/decentralization of an activity are very significant. An activity may operate in several locations. Since the internal control system for the activity may vary among locations--in design and/or operation--it may be necessary to perform separate internal control evaluations for each location.

Once the primary activities have been identified, the segments to be evaluated should be listed. This list should provide the structure for organizing and managing the overall evaluation process.

Committing Staff Resources

Personnel and Supervision
A sufficient level of staff resources needs to be committed to the department's internal control evaluation process on an ongoing basis. Ongoing activities should be distinguished between periodic activities. Ongoing activities are related to overall management responsibilities for maintaining and monitoring the effectiveness of internal controls for all departmental activities. Periodic activities are useful to take a "fresh look" at a system's effectiveness, including the effectiveness of ongoing activities.

Assignments should be made to those who manage the activities being evaluated and to individuals who assess the adequacy of evaluation efforts. Both groups need a good understanding of the activity or business process being evaluated so that they can make appropriate judgements. Specific measures that should be considered to provide this understanding, as well as assure the necessary quality, include the following:

- Orientation and training -- Sessions should be provided to explain the objectives of (and procedures) for conducting internal control monitoring efforts.
- Assignment of personnel -- Use of a "team" approach is encouraged in conducting evaluation activities. This provides assurance that the limitations of one individual can be offset by the strengths of another.
- Supervision -- Adequate supervision of personnel involved in the assessment and review processes must be provided.
- Technical assistance -- Should be developed and provided to employees assigned to the process. The department's internal auditor should routinely

provide assistance. Periodic meetings of key personnel involved in the process may also promote information sharing.

- Monitoring -- A monitoring system should be developed to assure that evaluation activities are performed adequately. A department may use an individual or small group to test the usefulness of evaluation activities or it may coordinate separate, limited reviews of the evaluation process by the internal auditor.

Establish a System to Monitor Evaluation Efforts

A system should be established to monitor the accomplishment of the various tasks that make up the department's overall evaluation efforts. This system should be used to provide reasonable assurance to the DSO that:

- the head of each activity maintains, monitors and modifies internal controls over their area of responsibility,
- the head of each activity maintains sufficient documentation related to the five components of internal control sufficient to demonstrate the achievement of the objectives of internal control,
- for each activity evaluated during the department-wide evaluation, documentation is prepared disclosing all aspects of the evaluation, and
- plans are prepared in sufficient detail with corresponding timelines for correcting internal control weaknesses identified by departmental monitoring efforts (including both ongoing monitoring and separate evaluations).

The system should be able to:

- Summarize information regarding the results of monitoring efforts, with consideration to other independent reviews (e.g., internal audit, Office of the Auditor General, etc.), in a manner to support the required external reports.

- Summarize information about the effectiveness of each of the five components of the department's overall internal control structure.

- Gather other data necessary to evaluate actions necessary to improve the internal control structure (e.g., status of training, impact on performance appraisals, other personnel actions.)

Schedule the Evaluations

Scheduling department-wide evaluations should be done carefully with special consideration given to resource availability, the effectiveness of departmental monitoring efforts, and the cyclical nature of certain activities. It is necessary to

ensure that sufficient evaluative work is scheduled and completed throughout the biennial period to provide a basis for the required external reports.

Conduct and Document Evaluation Efforts and Conclusions

Departmental evaluation efforts should be comprised of activity level monitoring efforts and department-wide evaluations. This concept is very important to consider when developing plans to conduct a department-wide evaluation.

Conducting Activity Level Evaluations
The nature, scope and frequency of monitoring efforts (both ongoing monitoring procedures and separate evaluations) varies among activities. One approach does not fit all, due to operating schedules; the volatility of applicable laws, rules, and regulations; the implementation of significant changes to work processes; the criticality of the activity in relation to department-wide objectives; recent audit citations, etc.

The DSO should confer with departmental management and the internal auditor to understand the sufficiency of monitoring efforts by each of the department's activity level components. This can be done throughout the biennial period.   This effort by the DSO is, in itself, a department-wide monitoring effort that should contribute to assurances the DSO is responsible for obtaining (concerning the status of the department's internal control structure at the close of each biennial period).

In reviewing the monitoring activities of each activity level component, the DSO should be concerned that the respective managers have evaluated the effectiveness of each of the five components of internal control governing their area of responsibility. These components serve as both the standard and criteria for an effective internal control structure. Furthermore, conclusions about each component of internal control should be used to formulate overall conclusions about the activity's achievement of its specific objectives, and its achievement of the objectives of internal control.

The DSO should utilize the system to monitor activity level evaluation efforts to summarize results of activity based reviews. Summaries can facilitate identification of common problems across the department, material weaknesses in internal controls, and other deficiencies isolated to one activity level component. This information should also be used to support the DSO's department-wide evaluation strategy.

Conducting the Department-wide Evaluation
In conducting "entity-wide" evaluations (in the context of this document, entity-wide is the same as "department-wide"), the COSO internal control framework recommends that senior management evaluate (at least) those primary activities that are critical to the achievement of the department's mission and department-

wide objectives.   Much of this evaluation should incorporate results from the activity level evaluations, performing additional evaluative work only when necessary to support the conclusions about the effectiveness of the department's overall internal control structure.

Documentation of Evaluation Efforts

The DSO should maintain centralized documentation regarding the <u>overall monitoring plan</u>.   This information should be kept current to reflect changes to the internal control structure and the evaluation approach. This information should form the basis for the department's overall monitoring activities and eventual conclusions about the effectiveness of the internal control structure. The documentation should include, at a minimum:

- A statement of the department's mission and related department-wide objectives.
- A description of the department and each of its activities, identified during the segmenting phase of planning, and its relationship to department-wide objectives.
- Reports from each departmental activity pertaining to the evaluation of internal controls in their area of responsibility.
- Assignments related to the department-wide evaluation efforts.

A primary requirement to an effective evaluation process is developing and maintaining appropriate written documentation to <u>substantiate conclusions</u> from the evaluation process. This documentation, which will typically be prepared by various levels of management, should indicate whether measures are in place to achieve the objectives of internal control.

Effective documentation will assist management in:

- Collecting and reviewing appropriate evidence about the effectiveness of the internal control structure, relative to each component of the internal control structure.
- Being proactive in the development of new control activities as changes occur in the system or underlying activities of the department.
- Educating and training employees about the importance of internal controls and how performance of their job responsibilities contributes to effective internal controls.

In particular, documentation should be maintained for activities conducted in connection with monitoring efforts and follow-up actions to provide a permanent record of the methods used, the personnel involved and their roles, the key factors considered, and the conclusions reached. This information will be useful for reviewing the validity of conclusions reached, evaluating the performance of

individuals involved in evaluation activities, and performing subsequent evaluation activities.

The DSO is responsible for ensuring that adequate documentation is maintained to support conclusions reached in the evaluation process. References to all applicable documentation should be explained, as applicable. It is not necessary to duplicate documentation throughout the organization. Instead, managers should explain the relevance of documentation contained elsewhere (i.e., policies and procedures) and their impact on internal controls. In some instances, the documentation of activity level objectives, risks, and controls may be presented as a "road map" that provides references to supporting documentation (e.g., policies and procedures).

Reference to Evaluation Tools

An effective internal control evaluation tool set will facilitate both the evaluation and the reporting process. In performing evaluations, the same five components used as the basic framework for defining internal controls can also be used as "criteria" when evaluating the system. As a result, tool sets (to be used by evaluators) are often constructed in reference to these same five components.

Overall, tool sets should be based on objectives and risks (associated with the department) and allow for the consideration of the various control activities in place. The tool set should provide for a good exchange of information and facilitate communication, both internal and external. Finally, the tool should allow for documentation of both ongoing monitoring and separate evaluations of the internal control structure.

The Office of Financial Management (OFM) has researched several tool sets used for the evaluation of internal controls. Based on these reviews, OFM has determined that the basic requirements of an effective tool set include:

- Facilitates the evaluation "thought process."
- Is automated.
- Able to readily accumulate data and summarize information.
- Allows for customization.

Facilitates the Evaluation "Thought Process"
An evaluation tool set should be formatted to facilitate the thought process. The best tool set is not necessarily one that gives the evaluator a series of steps to follow. Following a series of steps may not allow an evaluator to explore the various differences within their portion of the department. All evaluation tools should complement the typical evaluation process by requiring the identification of measurable objectives, analysis of risks, evaluation of control techniques and monitoring activities, and overall conclusions about the effectiveness of internal controls.

Automation
An important aspect of an efficient and effective evaluation tool is automation. This allows for capturing of data in electronic format at the lowest level in the department so that information does not have to be re-produced throughout the department. Also, capturing data early in the process allows for accumulation of the data to identify areas with similar problems and weaknesses. Finally, automated information can be transmitted quickly from site to site via electronic networks.

Data Accumulation
A useful tool set must be able to accumulate data, summarize the information by a variety of key data elements and display it in a logical manner that facilitates the evaluation. The tool should provide for recording results of both ongoing monitoring and separate evaluations. The tool should also allow for the information to be summarized in a variety of ways so it can be reviewed, and subsequently reported, in a timely manner.

Allows for Customization
An effective tool allows the evaluator to modify the tool to suit their needs. If a component of the tool does not accommodate your evaluation objectives, then you should modify it to meet your needs. Likewise, if the evaluator believes additional information should be included to provide a better understanding of the internal controls, the tool should allow for this.

In summary, there are many tool sets available for conducting evaluations of internal controls. OFM offers access to selected tools, in an electronic format, at its web site (URL: http://www.state.mi.us/dmb/ofm/). As noted, the most effective tool will be one that facilitates the thought process for conducting the evaluation, is automated, allows for efficient accumulation of data, and allows for customization to meet an evaluator's unique needs.

SYSTEM OF REPORTING

Overview

The Management and Budget Act requires the head of each principal State department to issue a report (to the Governor, the Office of the Auditor General, the Senate and House Appropriations Committees, and the State Budget Officer/DMB Director) summarizing results of its evaluation of the department's internal control structure. The report is due on May 1 (of each odd number year) based on an evaluation of the system as of October 1 (of all even numbered years). This report must be accompanied by a second report, prepared by the department's internal auditor, describing the adequacy of the evaluation process used.

The "System of Reporting" section of this document is to be used by each State department to communicate the results of internal control evaluations. The section contains two components:

- Reporting by Management (the Department Director, a designated senior official, and evaluating managers)

- Reporting by the internal auditor

This guidance is supplemented by sample reports contained in the Administrative Guide to State Government (Procedure 1270.01).

Reporting by Management (the Department Director, a designated senior official, and evaluating managers)

A department's evaluation (regardless of the evaluation tools used and internal reports maintained) must provide the basis for departmental leadership to conclude whether the internal control structure has been designed to prevent, or to detect, potential risks and whether controls are working as prescribed. As detailed in the general framework, the components of an internal control structure include the overall control environment, risk assessment and control activities; information and communication systems; and control monitoring techniques. These internal controls must provide reasonable assurance that measures are being used to:

- Develop reliable financial reports.

- Promote effective and efficient operations, including the safeguarding of State assets.

- Encourage compliance with applicable laws, rules, and regulations (including prescribed managerial policies).

As noted previously, the department director must prepare and submit an external report (every two years) summarizing the results of its internal control evaluation process. Any material inadequacy or weakness discovered in connection with the evaluation must be described as well as time schedules for correcting the material deficiencies.

To appropriately summarize the findings of all underlying evaluation efforts, managerial staff assigned to evaluate specific objectives, activities, or components should provide a letter of assurance to the department director related to the results of their specific evaluations. In addition, the results of monitoring efforts which occur throughout the two-year period should also be routinely communicated to senior management. The designated senior official must review the findings reported by the various managers, identify material internal control weaknesses (from a department-wide perspective), and prepare a comment letter to the department director. The letter(s) from evaluating managers and the letter from the designated senior official should be considered internal reports and maintained in department files as a component of the overall evaluation documentation.

Assessing whether an issue reported by an evaluating manager is a material inadequacy or weakness is a significant challenge assigned to senior leadership of State departments. To assist leadership in reaching conclusions related to materiality, we offer the following definitions to categorize deficiencies:

A **reportable condition** is defined as a matter coming to management's attention that in their judgement should be internally communicated because it represents either an opportunity for improvement or a deficiency in management's ability to operate a program, or administer a process, effectively and efficiently.

All reportable conditions should be communicated internally to the designated senior official.

A **material inadequacy or weakness** is a serious reportable condition in which the design (or operation) of the department's internal control structure does not adequately reduce, to an acceptable level, the risk that errors and irregularities can occur. Also, it is unlikely that the error (or irregularity) will be detected by management in a timely manner.

When assessing the seriousness of an internal control deficiency, one should assess the nature and likelihood of the adverse consequences that could result from the deficiency (without timely detection).

In addition, the:

- existence of related party or sensitive transactions;
- the potential for legal/regulatory issues; and
- the potential (or identification) of fraud

will all tend to elevate the materiality (i.e., seriousness) of any related deficiencies in controls.

Reporting by the Internal Auditor

In Michigan State government, internal auditors are responsible for reviewing the nature of the internal control evaluation activities upon which the department has based its external report. Based on this review, internal auditors must report as to whether the internal control evaluation was carried out by appropriate staff in a reasonable and prudent manner. This reporting responsibility should not prevent the internal auditor from actively consulting and assisting the designated senior official or evaluating managers.

Additionally, department internal auditors are required to report audits and investigations performed. This list must also be supplemented by a report identifying the proportion of time spent on each of the internal auditor's statutory responsibilities set forth in the Management and Budget Act.

GLOSSARY

Activity-level Evaluation
Evaluation of the internal control structure over a specific organizational component, several organizational components, or a specific process that seek to achieve a common business objective. The activity may correlate with a core business process that "cuts across" several organizational components.

Application Controls
Programmed procedures in application software and related manual procedures, designed to help ensure completeness and accuracy of information processing. Examples include computerized edit checks of input data, numerical sequence checks, and manual procedures to follow-up on items listed in exception reports.

Category
One of three groupings of objectives that all department-wide and activity level objectives fall into. The categories are *effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations.* Categories overlap, so any one objective might fall into more than one category.

Compliance
Conforming with laws, rules, and regulations applicable to a department.

Component
One of five elements of internal control within an internal control structure. The components are *control environment; risk assessment; control activities; information and communication;* and *monitoring.*

Computer Controls
(1) Controls performed by a computer; i.e., controls programmed into computer software (contrast with *Manual Controls*).
(2) Controls over computer processing of information, consisting of general controls and application controls (both programmed and manual).

Control
(1) A noun, used as a subject; e.g., existence of a control--a policy or procedure as a part of internal control. A control can exist within any of the five *components.*
(2) A noun, used as an object; e.g., to affect control--the result of policies and procedures designed to control; the result may or may not be effective internal control.

(3) A verb; e.g., to control--to regulate; to establish or implement a policy to affect control.

Corrective Control

A control designed to correct errors, omissions, and irregularities that have been detected (contrast with *Detective Control* and *Preventative Control*).

Criteria

A set of standards against which an internal control structure can be measured in determining effectiveness. The five internal control components, taken in the context of inherent limitations of internal control, represent criteria for internal control effectiveness for each control category.

Deficiency

A perceived, potential or real internal control shortcoming; or an opportunity to strengthen the internal control structure, to provide a greater likelihood that the department's objectives will be achieved.

Department-Wide Evaluation

An evaluation of the effectiveness of a department's overall internal control structure, based at least in part on conclusions drawn from *activity level evaluations*.

Detective Control

A control designed to discover an unintended event or result (contrast with *Preventative Control*).

Effective Control

(1) An internal control structure can be judged effective in each of the three categories respectively, if management (and any other governing body) has reasonable assurance of the following:
- they understand the extent to which the department's operational objectives are being achieved
- public funds are being used responsibly
- applicable laws and regulations are being complied with
- A state or condition of internal control within the internal control structure.

Entity

An organization of any size, established for a particular purpose. An entity may be, for example, an agency, a division, a department, or a work unit. In higher education, an entity may be a college, a department, or an administrative unit.

Ethical Values

Moral criteria enabling a decision-maker to determine an appropriate course of behavior. These values should be based on what is "right," and may go beyond what is "legal."

Financial Reporting

Used with "objectives" or "controls"—relating to the reliability of published financial statements.

General Controls

Policies and procedures to help ensure the continued proper operation of computer information systems. Including controls over data center operations, system software acquisition/maintenance, access security, and application system development/maintenance. They also support the functioning of programmed application controls. Other terms used to describe general controls are *general computer controls* and *information technology controls.*

Inherent Limitations

Restrictions applicable to all internal controls within an internal control structure. The limitations of human judgement; resource constraints, the need to consider the cost of controls in relation to expected benefits; the reality that breakdowns can occur; and possibilities of management override and collusion.

Integrity

The quality or state of being of sound moral principle; uprightness, honesty, and sincerity; the desire to do the "right" thing; and to profess and live up to a set of values and expectations.

Internal Control System

A process, effected by the director, management, and support staff of each State department, designed to provide reasonable assurance towards accomplishment of each principal departments' mission, objectives and goals. Internal Control, Internal Control System, Internal Control Structure, System of Internal Control, Management Control System, and Internal *Accounting and Administrative* Controls are referred to interchangeably throughout this general framework document.

Management Controls

Controls performed by one or more managers at any level in an organization.

Management Intervention
     Management's actions to overrule prescribed policies or procedures for
     <u>legitimate</u> purposes. Management intervention is usually necessary to deal
     with non-recurring and non-standard transactions or events that otherwise
     might be handled inappropriately by the system (contrast with *Management
     Override*).

Management Override
     Management's overruling of prescribed policies or procedures for <u>illegitimate</u>
     purposes, with the intent of personal gain or to enhance presentation of a
     department's financial condition or compliance status.

Management Process
     The series of actions taken by management to run a department. An internal
     control structure is a part of and integrated with the management process.

Manual Controls
     Controls performed manually, rather than by computer.

Operations
     Used with *objectives* or *controls*—relating to the effectiveness and efficiency of
     a department's programs or activities.

Policy
     Management's directive as to activities affecting control; the basis for
     procedures for policy implementation.

Preventative Control
     A procedure or policy designed to avoid an unintended event or result
     (contrast with *Corrective Control* and *Detective Control*).

Procedure
     An action to implement a policy.

Process
     A series of logically related tasks, involving people, machines, and methods;
     used to change materials, resources, or data (input) into goods or services
     (output).

Published Financial Statements
     Financial statements, interim and condensed financial statements and
     selected data derived from such statements (e.g. monthly budgetary status
     reports) publicly reported.

Reasonable Assurance

> The concept that internal control, no matter how well designed and operated, cannot guarantee a department's objectives will be met--because *inherent limitations* exist in <u>all</u> internal control systems.

Reliability of Financial Reporting

> Used in the context of published financial statements; the preparation of financial statements fairly presented in conformity with generally accepted (or other relevant and appropriate) accounting principles and regulatory requirements for external purpose, within the context of materiality. The following five basic financial statement assertions support fair representation:
> - existence or occurrence
> - completeness
> - rights and obligations
> - valuation or allocation
> - presentation and disclosure
>
> When applied to interim or condensed financial statements or to selected data derived from such statements, both the *factors representing fair presentation* and the *assertions* apply only to the extent they are relevant to the presentation.

Reportable Conditions

> A weakness in the design or functioning of internal control that, in management's opinion, warrants that the condition should be internally communicated because it represents either an opportunity for improvement or a deficiency in management's ability to operate a program, or administer a process, effectively and efficiently.

Work Process

> A synonym for *Process.*

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